

## **WHY IS EVERYONE TALKING ABOUT DELAWARE TRUSTS?**

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# Why Is Everyone Talking About Delaware Trusts?\*

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## I. INTRODUCTION

Delaware is a trust friendly state. For more than a century, Delaware has assisted wealthy families in accomplishing objectives such as teaching younger generations about the responsible stewardship of wealth and philanthropy while simultaneously maximizing the investment return on family assets, protecting family wealth from creditors and saving income taxes. See, R. Nenno, *Perpetual Dynasty Trusts: Tax Planning and Jurisdiction Selection*, ALI-ABA Planning Techniques for Large Estates, 509-651 (Apr. 2007), available at [www.ali-aba.org](http://www.ali-aba.org).

It is for these reasons and the reasons set forth in this outline that almost every major institutional trustee is either based in Delaware or has opened an office to provide trust services there. It is also for these reasons that many wealthy families have established their own trust companies (limited purpose trust companies) in Delaware. A list of institutional trust companies and limited purpose trust companies may be found at [www.banking.delaware.gov](http://www.banking.delaware.gov). It should be obvious to the reader that nearly all national institutional trustees are open in Delaware for trust business.

However, it is not the purpose of this outline to deliver a sales pitch for Delaware trust business. Rather, it is the purpose of this outline to explain why so many institutional trustees and family offices have moved trust operations to Delaware and why so many trust attorneys are working with their wealthy clients to change the situs of existing trusts to Delaware. The explanation may lead many to work on trust legislation in their own states. The explanation will also demonstrate that it is not necessary for wealthy trustors to abandon their relationships with local advisers and trust attorneys to avail themselves of the many advantages of Delaware Trust law.

So, why is everyone talking about Delaware trusts?

## II. FREEDOM OF DISPOSITION

- A. Statutory Provisions. Delaware trust law is based on the premise that a trustor has the legal right to control the investment decisions, management decisions and trust distribution decisions of trusts created by a trustor and funded with the trustor's assets. This fundamental principle of Delaware trust law allows a trustor to modify the duty to diversify trust investment, and to permit the trustee to hold high risk portfolios, closely held business interests, and overly concentrated stock

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positions in the stock of family businesses gone public without fear of liability. It allows for the enforceability of subjective distribution standards in the trust document, including those common in incentive trusts, and the ability of the trustor to determine the trust functions that will be performed by the institutional trustee and those that will be performed by others (trust advisers) so that the administration of the trust will be more economical. Rachel Emma Silverman, *How Many Trustees Do You Need?* Wall St. J., July 12, 2007, at B5.

1. Trust Instrument Controls. Delaware law gives maximum effect to the wishes of the trustor as expressed in the governing instrument. 12 Del. C. § 3303(a). This specific statutory provision states that the terms of a governing instrument may expand, restrict, eliminate or otherwise define the rights of beneficiaries, including the right of a beneficiary to be informed of the existence of the trust, the grounds for the removal of a fiduciary, and the fiduciary's powers, duties and standard of care. *Id.*

### ' 3303. Effect of provisions of instrument

(a) Notwithstanding any other provision of this Code or other law, **the terms of a governing instrument may expand, restrict, eliminate or otherwise vary the rights and interests of beneficiaries, including, but not limited to, the right to be informed of the beneficiary=s interest for a period of time, the grounds for removal of a fiduciary, the circumstances, if any, in which the fiduciary must diversify investments, and a fiduciary=s powers, duties, standard of care, rights of indemnification and liability** to persons whose interests arise from that instrument; provided however, that nothing contained in this section shall be construed to permit the exculpation or indemnification of a fiduciary for the fiduciary=s own willful misconduct or preclude a court of competent jurisdiction from removing a fiduciary on account of the fiduciary=s willful misconduct. The rule that statutes in derogation of a common law are to be strictly construed shall have no application to this section. **It is the policy of this section to give maximum effect to the principle of freedom of disposition and to the enforceability of governing instruments.** [Emphasis added].

The purpose of the statute is plain. The trustor has the freedom to dispose of his or her assets in any way the trustor chooses. Trustor=s intent is paramount.

For example, prior to the enactment of ' 3303, the Delaware Supreme Court upheld a Chancery Court decision removing and surcharging PNC Bank as trustee of a trust for, among other things, failing to inform a person that he was the beneficiary of a trust and rebuffing that person=s attorney in his efforts to obtain information about the trust. *McNeil v. McNeil*, 798 A.2d 503 (Del. 2002). Section 3303 clearly reverses *McNeil*

on the issue of notice if the trust document includes language allowing the trustee to hold the trust, and information about the trust, secret for some period of time

2. Trustee=s Reliance on Trust Instrument. The trustor=s statutory right to Aexpand, restrict, eliminate or otherwise vary... a fiduciary=s powers, duties [and] standard of care@ by the express terms of the governing instrument, subject only to the fiduciary=s duty not to engage in Awillful misconduct@ would have little meaning were it not for the trustee=s statutory right to rely on the terms of the trust instrument. In this regard, 12 Del. C. ' 3586 states:

**' 3586. Reliance on trust instrument**

A trustee who acted in good faith reliance on the terms of a written trust instrument is not liable to a beneficiary for a breach of trust to the extent the breach resulted from the reliance. 12 Del. C. ' 3586.

Similarly, 12 Del. C. ' 3302(e) states:

**' 3302. Degree of care; authorized investments**

(e) Any fiduciary acting under a governing instrument shall not be liable to anyone whose interests arise from that instrument for breach of fiduciary duty for the fiduciary's good faith reliance on the express provisions of such instrument. The standards set forth in this section may be expanded, restricted or eliminated by express provisions in a governing instrument.

It is the trustee=s right to rely on the express terms of the trust instrument that allows the trustee to administer a trust without fear of retribution by disgruntled beneficiaries.

- B. Trustee Protection. To ensure the enforceability of the provisions of the trust agreement, Delaware enacted legislation to protect a trustee acting in accordance with the trust instrument. Key parts of the legislation include a shortened claims period limiting the time during which a Delaware trustee may be sued and an extension of the "virtual representation doctrine" so that those with a future interest in the trust may be bound by others with an identical preceding interest.

1. Contesting the Trust. Delaware law provides that a judicial proceeding to contest whether a trust was validly created may not be initiated later than the first to occur of: (i) 120 days after the date the trustee notified the potential claimant of the existence of the trust, the trustee's name and address, whether the person is a beneficiary and the time allowed for initiating the judicial proceeding to contest the trust (the foregoing

provision allows the trustor of a revocable trust to confront a potential contestant during the trustor's lifetime); (ii) two years after the trustor's death; (iii) if the trust was revocable at the trustor's death and the trust is specifically referred to in the trustor's Will, the time in which a petition for review of the Will could be filed in Delaware; and (iv) the date the potential claimant's right to contest was otherwise precluded by adjudication, consent or other limitation under Delaware law. 12 Del. C. § 3546(a). Under Delaware law, the period of time during which a trustor's Will may be contested is generally six months after the filing of the Will in the Register of Wills Office for purposes of subsection (iii) above. 12 Del. C. § 1309(a).

- (a) The concept of "pre-mortem validation" has gained popularity in recent years. The idea that a person should be permitted to defend an estate plan while alive and mentally alert, rather than relying upon attorneys to defend it after death, is just good sense. Delaware has permitted the form of pre-mortem validation set forth in subsection (i) of the above quoted statute since 2003.
- (b) Delaware also accepts the validity of "no contest" clauses in trust instruments. 12 Del. C. § 3329(a). Coupling the pre-mortem validation provision with a no contest clause in a trust is an effective way to avoid litigation after the trustor's death over the validity and effectiveness of the trust instrument.

- 2. Limitation on Actions Against a Trustee. Delaware law provides that a beneficiary may not initiate a proceeding against the trustee for breach of trust after the first to occur of: (i) two years following the date the beneficiary was sent a report that adequately disclosed the facts constituting a claim or (ii) the date the proceeding was otherwise precluded by adjudication, release, consent or other limitation under Delaware law. 12 Del. C. § 3585(a). The two year claims period applies to minor, incapacitated and unborn persons and persons whose identity or location is unknown whose interest is represented under Delaware's virtual representation statute. 12 Del. C. § 3547. In 2008, 12 Del. C. § 3585 was amended by the Delaware legislature to add a new five year statute of repose for breach of trust actions. In cases where the two-year limitation period does not apply, the new limitations period absolutely bars breach of trust claims five years following the first to occur of (i) the removal, resignation or death of the trustee; (ii) the termination of the beneficiary's interest in the trust; or (iii) the termination of the trust.
- 3. Beneficiary's Consent. Delaware law provides that a beneficiary may not hold a trustee liable for a breach of trust if the beneficiary consented to the conduct constituting the breach, released the trustee from liability for the breach or ratified the transaction constituting the breach unless the

beneficiary was so induced by improper conduct of the trustee or the beneficiary did not know at the time the beneficiary's rights or material facts the trustee knew or should have known. 12 Del. C. § 3588.

4. Virtual Representation. Delaware law provides that the interest of “a minor, incapacitated, or unborn person, or a person... whose identity or location is unknown and not reasonably ascertainable” may be represented and bound by another with substantially identical interests. 12 Del. C. § 3547(a). Virtual representation applies for all purposes including judicial proceedings and such non-judicial matters as releasing the trustee, consenting to the conduct of the trustee or ratifying a transaction engaged in by the trustee. 12 Del. C. § 3588. In the case of a minor or incapacitated beneficiary, a custodial parent or guardian may represent and bind the beneficiary. 12 Del. C. § 3547(c). A “presumptive remainder beneficiary” (one who would take if the trust terminated at that time without regard to the exercise or non-exercise of a power of appointment) may represent and bind contingent remainder beneficiaries including adults and charities. 12 Del. C. § 3547(b). A custodial parent may sign on behalf of a minor or incapacitated beneficiary only if “there is no material conflict of interest between the minor or incapacitated beneficiary and either of such beneficiary's parents with respect to the particular question in dispute”. 12 Del. C. § 3547(c). The foregoing provision often avoids the need to appoint a guardian ad litem.

### **III. FAVORABLE TRUST LAW**

- A. Statutory Provisions. Delaware has developed a substantial body of favorable trust law. The trust law is consistently monitored by a select group of the Delaware Bar Association that continually reviews and modifies the law to maintain Delaware's preeminent position in the field of trust law.
  1. Perpetual Trusts. Delaware abolished the common law rule against perpetuities applicable to trusts in 1986 and enacted legislation allowing perpetual trusts in 1995. 25 Del. C. § 503. Under Delaware law, a trust may have perpetual existence. 25 Del. C. § 503. There is a limitation for real estate held by deed in trust name that applies the old 110 year rule against perpetuities to the real estate. 25 Del. C. § 503(b). However, the statute expressly excludes real estate held as an intangible through an entity such as a “corporation, limited liability company, partnership, statutory trust, business trust or other entity” where the entity ownership interest is held by the trust instead of the real estate itself. 25 Del. C. § 503 (e). As a result:
    - (a) Many trustors are establishing “dynasty trusts” in Delaware to which they allocate their GST exemption so that the trust may continue in perpetuity free of federal estate and federal generation

skipping taxes and free from the claims of creditors of the beneficiaries. Non-exempt trusts are also often established as perpetual trusts while the federal estate tax rate and the generation skipping transfer tax rate are the same. The viability of this planning technique, and the others discussed below, will depend upon the provisions of any laws that reinstate the federal estate tax and the federal generation skipping transfer tax.

- (b) Many trustors are establishing dynasty trusts funded with large life insurance contracts insuring the trustor's life and in some cases the joint lives of trustor spouses, allocating GST exemption to the premium payments thereby leveraging GST exemption to create family wealth that will be administered in perpetuity through the dynasty trust.
- (c) Many trustors are establishing intentionally defective grantor trusts for income tax purposes, i.e., a trust that includes powers that will cause the income to be taxable to the trustor. The trustor will then gift "seed money" to the trust and allocate a portion of the trustor's applicable exclusion amount and lifetime GST exemption. The trust will then purchase an asset from the trustor (typically an asset the trustor expects will appreciate substantially) in exchange for a promissory note with interest at the appropriate applicable federal rate. The sale of the assets to the trust will not cause the trustor to recognize gain because, for income tax purposes, the trustor and the trust are the same entity. If the purchased assets appreciate at a rate faster than the interest rate on the note, the trustor will have successfully transferred the appreciation out of his or her estate and allocated GST tax exemption so that the trust may continue in perpetuity.
- (d) Where the power to substitute is the power chosen to create an intentionally defective income trust, Delaware law confirms that, notwithstanding the terms of a governing instrument, the fiduciary responsible for investment decisions has a "fiduciary duty" to determine that the substituted property is of equivalent value to the property withdrawn. 12 Del. C. § 3316. This provision was added to ensure compliance with the Internal Revenue Service position on this issue.

2. Favorable Income Tax Laws. Delaware does not tax that portion of trust income and capital gains accumulated and set aside for future distribution to nonresident beneficiaries. 30 Del. C. § 1636(a). If all of the beneficiaries of a Delaware trust are nonresidents, the trust pays no Delaware state income tax at all. Id. Many non-resident trusts (including many from New York) have been moved to Delaware to avoid state

income tax that would otherwise apply. See, for example, N.Y. Tax Law § 605(b)(3)(D) exempting resident trusts from New York income tax where all of the trustees are domiciled in a state other than New York, the entire trust corpus is located outside the State of New York and all income and gain of the trust are derived from or connected with sources outside the State of New York. Clients with existing trusts in high income states often move their trusts to Delaware in anticipation of a transaction that will result in a substantial capital gain (i.e., a sale of a block of low-basis stock) in order to avoid the state income tax that would be imposed as a result of the transaction. Delaware does not have a tax on intangible personal property and there are no other franchise taxes, gross receipts taxes or hidden fees that apply to Delaware trusts.

3. Prudent Investor Rule. Delaware adopted its version of the uniform Prudent Investor Act in 1986. 12 Del. C. § 3302(b). Delaware permits a trustee to acquire virtually every kind of investment and judges the trustee's investment performance based upon the performance of the entire portfolio of the trust and not on an asset by asset basis. 12 Del. C. § 3302(c). Where the terms of a governing instrument direct the fiduciary to retain specified trust property as a trust investment, the duty of diversification otherwise applicable to the fiduciary with respect to such property shall be deemed to be waived and the fiduciary shall be exonerated from liability for retaining the property except in the case of willful misconduct proved by clear and convincing evidence in the Court of Chancery. 12 Del. C. § 3304.
4. Asset Protection – Trust Beneficiary. Delaware has always provided strong asset protection against creditors of a non-trustor beneficiary. 12 Del. C. § 3536. A creditor of a beneficiary of the trust has only such rights against the beneficiary's interest in the trust as shall be expressly granted to such creditor by the terms of the trust instrument or by the laws of the State of Delaware. Id.
  - (a) State law specifically protects a beneficiary's interest in a trust from actions, at law or in equity, against the trustee or the beneficiary that seek to: (i) compel the trustee or the beneficiary to notify the creditor of a distribution from the trust; (ii) compel the trustee or the beneficiary to make a distribution from the trust; (iii) prohibit a trustee from making a distribution from the trust to or for the benefit of a beneficiary; and (iv) compel a beneficiary to exercise a power of appointment or a power of revocation over the trust. 12 Del. C. § 3536(a).
  - (b) A beneficiary may not waive the spendthrift protection of the Delaware statute and the interest of a trust beneficiary is fully protected until actual distribution of the trust property is made to

the beneficiary. Id. Regardless of whether a beneficiary has an outstanding creditor known to the trustee, a trustee may make direct payment of any expense on behalf of the beneficiary, as permitted by the trust instrument, and is not liable to any creditor for paying the expenses of a beneficiary. Id.

- (c) Where the trustor is also a beneficiary of a trust, a spendthrift provision will not prevent the trustor's creditors from satisfying their claims against the trustor's interest in the trust to the extent of the trustor's contributions to the trust unless the trust falls within the Delaware Qualified Dispositions in Trust Act that protects self settled trusts. 12 Del. C. § 3536(c)(1). For purposes of the statute, if a trustor's sole retained beneficial interest in the trust is the right to receive discretionary distributions to reimburse the trustor's income tax liability attributable to the trust, that discretionary beneficial interest in the trust is protected. Id.
- (d) A beneficiary of a trust is not considered to be a trustor merely because of the lapse of a right of withdrawal (Crummey power) in any calendar year. 12 Del. C. § 3536(c)(1) and (2).
- (e) A creditor of a beneficiary has no right against the beneficiary's interest in a trust solely because the beneficiary has a limited or general power of appointment exercisable in a manner that will only take effect upon the beneficiary's death unless the beneficiary actually exercises the power in favor of the beneficiary, the beneficiary's creditors, the beneficiary's estate or the creditors of the beneficiary's estate, but then only to the extent the power is so exercised. 12 Del. C. § 3536(d)(1).
- (f) Where the beneficiary has a power to appoint during lifetime, the same rule applies. The beneficiary's creditors have no right against the interest of the beneficiary unless the beneficiary exercises the lifetime power to appoint the property to the beneficiary's creditors, the beneficiary's estate or the creditors of the beneficiary's estate and then only to the extent of the exercise. 12 Del. C. § 3536(d)(2).
- (g) Delaware law permits the beneficiary of a charitable remainder trust the right to release such beneficiary's interest, notwithstanding the spendthrift provision in the trust, in whole or in part, to a charitable organization that has a succeeding beneficial interest in the trust. 12 Del. C. § 3536(e).
- (h) A QTIP trust will not be treated as a self settled trust if the trustor's spouse holds a general or limited power of appointment over the

trust even if the trustor becomes a beneficiary of the trust subsequent to the death of the trustor's spouse. 12 Del. C. § 3536(c)(2).

- (i) The asset protection provisions of trusts that are not self settled are effective regardless of the nature or extent of the beneficiary's interest in the trust, whether or not such interest is subject to an exercise of discretion by the trustee and are effective regardless of any action taken or that might be taken by the trust beneficiary. 12 Del. C. § 3536(a). Moreover, where discretion is conferred upon the trustee, the trustee's exercise of discretion shall be considered proper unless a court determines that the discretion has been abused within the meaning of Section 187 of the Restatement (Second) of Trusts not §§ 50 and 60 of the Restatement (Third) of Trusts. 12 Del. C. § 3315(a). A creditor of a beneficiary may not directly or indirectly compel the distribution of a discretionary interest in a trust except to the extent expressly granted by the terms of the governing instrument or Delaware law. 12 Del. C. § 3315(b). A beneficiary eligible to receive distributions from a trust in the trustee's discretion has a discretionary interest within the meaning of the statute. Id.
- (j) Accounts held in Delaware banks, trust companies, savings institutions and loan associations are exempt from state law attachment under Delaware law. 10 Del. C. § 3502(b). This provision of Delaware law protects trust companies, among others, from the nuisance of complying with attachment orders. Once the beneficiaries of a Delaware trust deposit a trust distribution into a Delaware bank account, the distribution is protected from attachment attributable to state law claims.
- (k) There is a judicial exception to the spendthrift provision relating to a beneficiary's obligation to provide separate maintenance to a spouse. *Garretson v. Garretson*, 306 A.2d 737 (Del. 1973). The *Garretson* case involved a wife seeking to compel a husband who deserted her to provide support to the wife and dependents from a third party trust. Id. at 740. The Delaware Supreme Court ruled in favor of the wife noting that the result may be "entirely different" if the parties were divorced and the wife lost her status as wife. Id. at 742. Delaware goes so far as to bar a creditor from attaching the interest of a beneficiary even when the beneficiary commits a willful tort. *Parsons v. Mumford*, 1989 WL 63899 (Del. Ch. 1989); *Gibson v. Speegle*, 1984 Del. Ch. LEXIS 475 (1984).

5. Asset Protection Trust – Trustor. Delaware enacted a self settled asset protection trust law "The Qualified Dispositions in Trust Act" in 1997. 12

Del. C. § 3570, et. seq. (“Act”). The Act provides asset protection to certain self settled trusts permitting a trustor to transfer the trustor’s own assets through a qualified disposition to an irrevocable trust, retain certain beneficial interests in the trust and protect those assets from the claims of the trustor’s creditors. Id. A creditor’s claim against a Delaware asset protection trust is barred unless (i) the claim arose before the qualified disposition and suit is filed not later than four years after the date of the qualified disposition or one year after the creditor discovered or should have discovered the qualified disposition or (ii) the claim arose after the qualified disposition and suit is filed within four years after the qualified disposition. 12 Del. C. § 3572(b). Under the Act, the trustor may retain several powers which include, but are not limited to, the following: (i) the right to consent to or direct investment decisions; (ii) the power to veto distributions of income or principal from the trust; (iii) the power to appoint advisers who have authority to consent to or disapprove distributions from the trust and advisers to direct the investment of the trust assets; (iv) the power to replace trustees or advisers with persons who are not related or subordinate to the trustor; (v) the right to retain a limited power of appointment over the trust assets exercisable by the trustor’s Last Will and Testament or other written instrument effective upon the trustor’s death; (vi) the right to retain current income distributions; and (vii) the right to retain the ability to receive income or principal pursuant to broad discretion or a standard determined by the trustee and/or an adviser.

- (a) A great number of out of state trusts have migrated to Delaware to take advantage of the Act. The Act specifically allows a transfer by one trustee to a qualified Delaware trustee to be treated as a qualified disposition. 12 Del. C. § 3570(7).
- (b) A great number of doctors, lawyers, other professionals and individuals in high risk occupations are availing themselves of the Act.
- (c) Recently, individuals have been establishing trusts in compliance with the Act as a substitute for prenuptial agreements in order to protect the premarital estate without the awkwardness that accompanies the request for a prenuptial agreement.
- (d) Individuals have also been establishing trusts under the Act to avoid state income taxes, including state income taxes on substantial capital gains, for which avoidance of grantor trust treatment (and not asset protection) is the client’s primary objective. See “*Eliminate A Trust’s State Income Tax*,” *Trusts & Estates*, May 2006; Thomas R. Pulsifer and Todd A. Flubacher. Note, however, that the Internal Revenue Service is reconsidering a series of private letter rulings approving this technique. IR-2007-

127, 2007 WL 1966422 (I.R.S.).

- (e) Most Delaware trustees are following stringent rules to prevent abuse of the Act. There is a sense in the trust community that no one wants the first test case under the Act to be an abusive one. In most cases, only a portion of the trustor's assets are used to fund a "nest egg" trust under the Act.
- (f) Where a husband and wife make a contribution of property to a joint trust that is revocable by either or both of them and, immediately before the contribution, such property was owned by them as tenants by the entirety, that property and any accumulation thereto, while held in the trust during the lifetime of both spouses, is treated as tenants by the entirety for purposes of Delaware law. 12 Del. C. § 3334. Moreover, if a creditor of either or both spouses files an action against the trust, the sole remedy available to the creditor is an order directing the trustee to transfer the property back to both spouses as tenants by the entirety. Id.
- (g) The same rule applies where a husband and wife make a qualified disposition of tenants by the entirety property to a Delaware asset protection trust. 12 Del. C. § 3574. That property and any accumulation while held in the trust during the lifetime of both spouses is treated as though it were tenants by the entirety property. Id. The sole remedy of a creditor who files an action against the trust is an order directing the trustee to transfer the property back to both spouses as tenants by the entirety. Id.

6. Total Return Trust. Delaware was the first state to adopt total return legislation when it enacted 12 Del. C. § 3527 on June 21, 2001. The total return statute creates a simplified procedure that allows a "Disinterested Trustee" (such as a corporate fiduciary) to convert an income only trust to a total return trust without court proceedings. 12 Del. C. § 3527(b). The statute was enacted before the regulations under Internal Revenue Code § 643(b) became final. However, the drafters of the Delaware statute anticipated the regulations under § 643(b) and, accordingly, minimal revisions were required to the statute after those regulations became final. The statute allows a trustee to establish a unitrust rate from 3% to 5% in lieu of trust income and to allocate to the unitrust payment tax characteristics such as short-term and long-term capital gain. 12 Del. C. § 3527(h). The power of a trustee to convert an income trust to a total return trust or a total return trust to an income trust is, by statute, a law pertaining to the administration of a trust and is available to any trust administered in Delaware. 12 Del. C. § 3527(1).

- (a) Many older Delaware trusts have already converted from income only trusts to total return trusts.
  - (b) The situs of many out of state trusts has been moved to Delaware specifically for the purpose of allowing the Delaware trustee to convert an income only trust to a total return trust.
7. The Power to Adjust. Delaware law permits a trustee to adjust between principal and income to the extent the trustee considers necessary taking into account the nature, purpose and duration of the trust, the intent of the trustor, the identity and circumstances of the beneficiaries, the need for liquidity and preservation and appreciation of capital, the assets in the trust, the actual and anticipated effect of economic conditions and the anticipated tax consequences of the adjustment. 12 Del. C. § 6113(a) and (b). The power to adjust is, by statute, a law pertaining to the administration of a trust and is available to any trust that is administered in Delaware. 12 Del. C. § 6113(g).
8. Charitable Trust. In furtherance of its policy of giving maximum effect to the wishes of the trustor as expressed in the governing instrument, Delaware law prohibits a court from changing the purposes of a trust created for religious, charitable, scientific, literary or educational purposes unless “the purposes of the trust have become unlawful” under the constitution of the State of Delaware or the constitution of the United States or the trust no longer serves a charitable purpose. 12 Del. C. § 3303(b). This statutory standard for court intervention in a charitable trust matter should be compared with the traditional cy pres standard applicable in most jurisdictions. The cy pres standard generally allows a court to intervene when the charitable trust purposes become “impractical, impossible to achieve or wasteful” similar to the previous Delaware law. 12 Del. C. § 3541. Under Delaware law, a trustor has standing to maintain an action to enforce the charitable purposes of the trust and may designate another, whether that person is alive at the time of such designation or subsequently born, to enforce the charitable purposes of the trust. 12 Del. C. § 3303(b). Moreover, the Attorney General’s Office of the State of Delaware is charged with protecting the interest of the people relative to charitable trusts. The Attorney General’s Office typically maintains a hands off policy toward charitable trusts.
9. Purpose Trust. Delaware law permits the creation of a perpetual, non-charitable purpose trust. 12 Del. C. §§ 3555 and 3556. A purpose trust is one that is valid even though it may not have a charitable purpose and no identifiable beneficiary. Purpose trusts are often used for the care of pets, the preservation of collections, such as antique cars or trains, and the preservation and maintenance of a family compound. Delaware provides the same protection to a trustor of a non-charitable purpose trust it gives to

the trustee of a charitable trust, providing standing to the trustor and the trustor's designee to enforce the purposes of the trust. 12 Del. C. § 3303(b).

10. Decanting. Delaware law authorizes a trustee, that has authority under the terms of the trust instrument (the first trust) to invade principal for the benefit of one or more beneficiaries, to exercise such authority by appointing all or a portion of the principal subject to the power of invasion in favor of a trustee of a trust under a separate trust instrument (a second trust). 12 Del. C. § 3528(a). The Delaware decanting statute is discussed in more detail later in this outline.
11. Delaware Statutory Trust. Delaware law provides for the creation of a special business trust, known as a "Statutory Trust". 12 Del. C. § 3801 et seq. Family investments in virtually every kind of property may be managed through a statutory trust as an alternative to a limited partnership, a limited liability company, a corporation or other form of business entity. 12 Del. C. § 3801(a). A statutory trust may be taxed as a corporation, association, partnership, trust or otherwise in accordance with the provisions of the Internal Revenue Code and the manner elected by the trustee. 12 Del. C. § 3809. Statutory trusts provide limited liability to the trustee and the beneficiaries. 12 Del. C. § 3803. The governing instrument is paramount in determining the powers, duties and indemnity rights of the trustee and the classes of beneficial interest and rights of all of the beneficiaries. 12 Del. C. § 3823. Every Delaware statutory trust is required to have at all times at least one trustee which, in a case of a natural person, is a resident of the State of Delaware, and in all other cases is an entity with its principal place of business in Delaware. 12 Del. C. § 3807(a).
12. In Terrorem Clauses. A provision in a will or trust that would reduce or eliminate the interest of a beneficiary who initiates an action to contest the validity of the will or trust is enforceable under Delaware law with certain limited exceptions. 12 Del. C. § 3329(a). Unless the beneficiary bringing the contest substantially prevails, the beneficiary's interest in the will or trust may be eliminated on account of the contest.
13. Confidentiality. Delaware law places great emphasis on the confidentiality of matters relating to Delaware trusts. A trustor may direct the trustee (for a period of time) not to inform the beneficiary of the beneficiary's interest in the trust. 12 Del. C. § 3303(a). Delaware courts do not supervise the administration of trust unless called upon by an interested party to do so. 10 Del. C. § 6504. When issues of confidentiality and privacy are paramount to the parties, it is easy to obtain a court order to seal the record thereby keeping the trust agreement, the parties and their dispute private. Ch Ct R 5(g)(3). In addition, routine

trust petitions are filed in the Court of Chancery as “C.M.s” or Civil Miscellaneous matters and are not generally open to the public, even absent a court order sealing the record.

14. Excellent Court System. Delaware trust administration and trust interpretation cases are exclusively within the jurisdiction of the Delaware Court of Chancery and, upon appeal, the Delaware Supreme Court. The Court of Chancery is the same court that has exclusive jurisdiction over corporate law matters. Well educated, highly trained and specialized judges (called the Chancellor and Vice Chancellors) decide all disputes concerning trusts. There is no jury participation. Proceedings in the Court of Chancery (and upon appeal to the Delaware Supreme Court) are handled in a timely and efficient manner and counsel for the parties involved are expected to conduct themselves professionally and to respond promptly to the court and to court imposed deadlines.
15. Excellent Relationship Between the State Bar and the State Legislature. There is an excellent relationship between the Delaware Bar Association and the Delaware state legislature. The Delaware Bar Association handles all of its work through substantive committees which propose legislation to the Executive Committee of the Bar Association. Upon approval of the Executive Committee, the legislation is delivered to the Bar Association’s lobbyist. The Estates and Trusts Section of the Delaware Bar Association proposes legislation annually. The legislation is generally supported by the Delaware Bankers Association. In nearly all cases, the proposed legislation is passes and becomes law.
16. Directed Trusts. One of the most important reasons for trusts moving to Delaware is the Delaware directed trust statute. Delaware recognizes directed trusts and limits the liability of a trustee who acts upon the direction of an adviser appointed in the trust agreement to make an investment decision, a distribution decision or other decisions. 12 Del. C. § 3313. Directed trusts are discussed in more detail in Part IV of this outline.
17. Disabling Statute. In 2008, the Delaware legislature added a “disabling statute” patterned upon Section 814 of the Uniform Trust Code. 12 Del. C. § 3314. The statute provides in general that various powers held in a fiduciary capacity (such as the power to appoint trust property to the fiduciary personally or to the fiduciary’s estate or creditors or the creditors of the fiduciary’s estate) that might, absent the statute, be treated as general powers of appointment for federal transfer tax purposes, may only be exercised by the fiduciary for the fiduciary’s health, education, support or maintenance or by a special trustee who is an independent trustee. 12 Del. C. § 33314(e)(2). The statute is designed to prevent the inclusion of the trust assets in the estate of a fiduciary holding certain powers that

would be deemed general powers of appointment over the trust property.

- B. Trustee Protection. To ensure the full benefit of favorable Delaware trust law, Delaware enacted legislation to protect trustees acting in accordance with the trust instrument.
1. Life Insurance Trusts. A trustee has no liability for determining whether a contract of life insurance remains a proper investment for a trust, investigating or failing to investigate the financial strength of a life insurance company issuing a policy owned by the trustee, making a determination whether to exercise policy options, making a determination whether to diversify life insurance contracts or inquiring about changes in the health or financial condition of the insured. 12 Del. C. § 3302(d). When the trustee discloses this limitation of liability to the insured in its governing instrument or by separate writing delivered to the insured, the trustee is fully protected from liability. Id.
  2. Total Return Trusts. A trustee has no liability for failing to convert an income trust to a total return trust. 12 Del. C. § 3527(m).
  3. Acts of Predecessor. A trustee has no liability for the acts or omissions of a predecessor trustee absent actual knowledge of a breach of trust or information concerning a possible breach of trust that would cause a reasonable person to inquire and has no duty to examine the accounts and records of a predecessor trustee. 12 Del. C. § 3544.
  4. Asset Protection Trusts. A trustee has no liability to a creditor or any other person for counseling, drafting, preparation, execution or funding of a Delaware asset protection trust under both Delaware trust law and the Delaware Uniform Fraudulent Transfer Act. 12 Del. C. § 3572(d); 6 Del. C. § 1307(c).
  5. Prudent Investor Rule. Delaware adopted the Prudent Investor Rule for trustees with certain enhanced protections. 12 Del. C. § 3302. Delaware trustees are authorized to acquire “every kind of investment” and the propriety of an investment decision must be judged as part of the overall investment strategy and not on an investment by investment basis. 12 Del. C. § 3302(b). A Delaware trustee has no liability to a beneficiary for a loss or depreciation in the value of a trust absent proof of breach of trust. 12 Del. C. § 3583(b).
  6. Personal Liability for Trust Obligations. Delaware law provides that: (i) a trustee is not personally liable on a contract properly entered into by it in its capacity as trustee if the contract discloses the fiduciary capacity; (ii) a trustee is not personally liable for the debts, obligations and liabilities incurred by reason of the ownership or control of property held in a

fiduciary capacity, including liability incurred as a general or limited partner, or for violation of environmental law and such liability is enforceable only against the fiduciary fund; and (iii) a trustee is not liable for torts unless the fiduciary is personally at fault on account of the fiduciary's own willful misconduct proven by "clear and convincing evidence". 12 Del. C. § 3328.

7. Spendthrift Trusts. Delaware law provides that the trustee of a non-self settled spendthrift trust is protected against the creditor of a trust beneficiary. The law provides that a creditor shall have no claim against a trustee seeking any remedy affecting the beneficiary's interest in the trust and may not compel the trustee to notify the creditor of a pending distribution from the trust, compel the trustee to make a distribution from the trust (whether or not pursuant to an ascertainable standard) or prohibit a trustee from making distribution from the trust in payment of an expense of the beneficiary. 12 Del. C. § 3536(a)(i). A trustee administering a spendthrift trust under Delaware law may directly pay any expense of the beneficiary of the trust permitted by the governing instrument and may exhaust the income and principal of the trust for the benefit of the beneficiary even if the beneficiary has an outstanding creditor. 12 Del. C. § 3536(a)(iv). The statute was revised by the Delaware legislature in 2008 to provide even greater protection against claims made by creditors of trust beneficiaries. The revised statute provides that a creditor of a beneficiary has only such rights against the beneficiary's interest as are expressly granted to the creditor by the terms of the trust instrument or Delaware law. As a result of the modification to the statute, a beneficiary's interest in a Delaware trust is now protected against creditor claims even if the trust instrument does not include traditional spendthrift clause language denying creditors rights in the trust.
8. Discretionary Trust Distributions. In 2008, the Delaware legislature enacted 12 Del. C. § 3315 which provides that a trustee's exercise of a discretionary distribution power may not be overturned by a court except on account of "abuse of discretion" within the meaning of § 187 of the Restatement (Second) of Trusts. 12 Del. C. § 3315(a). Moreover, a creditor of a beneficiary, eligible to receive discretionary distributions from a trust, may not directly or indirectly compel the distribution of a discretionary interest. 12 Del. C. § 3315(b).

#### IV. DIRECTED TRUSTS – EXPORTING FAVORABLE DELAWARE TRUST LAW

- A. Introduction. Directed trusts are not new. Delaware (for example) has statutorily recognized the power of the trustor of a trust to restrict a trustee's authority to dispose of or otherwise deal with specified trust assets for more than twenty years. 12 Del. C. § 3313 (65 Laws 1986, ch. 422, § 5). Prior to the statute, going back to

the early 1900s, Delaware adopted the practice of allowing directed trusts to accommodate its wealthiest families.

In its earliest form, directed trusts tended toward the limitation of a trustee's power to sell specific trust assets without the consent or written direction of a person not serving as trustee. Today the limitations on a trustee's authority to deal with certain trust assets often affect all of the trustee's discretionary powers over the assets including voting decisions, management decisions, distribution decisions and other decisions previously solely within the realm of the trustee's discretion.

The desire of wealthy families to preserve their control over the stock of the corporation founded by their ancestors and the recognition that today's trusts often hold new kinds of unique trust investments have driven the issue of directed trusts. In fact, trustees faced with the fiduciary duty to diversify trust assets and deal impartially with income beneficiaries and remainder beneficiaries have welcomed the ability to limit their liability through the use of directed trusts.

The result has been the creation of a statutory framework authorizing a trustor (or the trustee and the trust beneficiaries through appropriate trust modification proceedings) to include in trust instruments a new regime for the administration of specific trust assets. In addition to the traditional trustee, the new regime often includes trust advisers. See, Rachel Emma Silverman, *How Many Trustees Do You Need?*

- B. Definition. A directed trust is a trust that removes one or more powers or discretions traditionally held by the trustee and vests that power or discretion in a person who is either a special trustee or not a trustee at all. The power or discretion can relate to investment decisions, management decisions, distribution decisions and any other decision affecting the administration of the trust. The starting point for the creation of directed trusts is the statutory framework that permits them coupled with the carefully worded language of the trust instrument.
  
- C. Statutory Recognition of "Advisers". A trustor's statutory power to dictate the rights and obligations of the beneficiaries and trustee through the express terms of a trust instrument and the trustee's statutory right to rely in good faith on the terms of the trust instrument for protection from liability are essential to the effective use of directed trusts. Three different approaches are illustrated below.
  - 1. UTC. Section 808(b) of the Uniform Trust Code states:

If the terms of a trust confer upon a person other than the trustee of a revocable trust power to direct certain actions of the trustee, the trustee shall act in accordance with an exercise of the power **unless the attempted exercise is manifestly contrary to the terms of the trust or the trustee knows the attempted exercise would constitute a serious**

**breach of a fiduciary duty** that the person holding the power owes to the beneficiaries of the trust. [emphasis added]

2. Third Restatement. Section 75 of the Third Restatement of Trusts states:

...[I]f the terms of a trust reserve to the settlor or confer upon another a power to direct or otherwise control certain conduct of the trustee, the trustee has a duty to act in accordance with the requirements of the trust provision reserving or conferring the power and to comply with any exercise of that power, **unless the attempted exercise is contrary to the terms of the trust or power or the trustee knows or has reason to believe that the attempted exercise violates a fiduciary duty that the power holder owes to the beneficiaries**. [emphasis added]

3. Delaware Provisions. The foregoing provisions for directed trusts should be compared with the more protective provisions adopted by Delaware and a few other states.

- (a) Delaware law recognizes a broad class of advisers including direction advisers, consent advisers and trust protectors. Where one or more persons are given authority by the terms of a governing instrument to direct, consent to or disapprove a fiduciary's actual or proposed investment decisions, distribution decisions or other decisions of the fiduciary, such persons shall be considered to be advisers and fiduciaries when exercising such authority unless the governing instrument otherwise provides. 12 Del. C. § 3313(a).
- (b) When a trustee acts in accordance with the directions of a trust direction adviser, the trustee will only be liable for its "willful misconduct".

#### Direction Provision

If a governing instrument provides that a fiduciary is to follow the direction of an adviser, and the fiduciary acts in accordance with such a direction, then **except in cases of willful misconduct on the part of the fiduciary so directed, the fiduciary shall not be liable** for any loss resulting directly or indirectly from any such act. 12 Del. C. § 3313(b). [emphasis added] The term willful misconduct means intentional wrongdoing and not mere negligence, gross negligence or recklessness. 12 Del. C. § 3301(g) and 12 Del. C. § 3301(h)(4).

- (c) The statutory standard of care required of a fiduciary acting on the consent of a Consent Adviser is only somewhat broader. When a

trustee acts with the consent of a Consent Adviser, the trustee will only be liable for its “willful misconduct” or “gross negligence”.

#### Consent Provision

If a governing instrument provides that a fiduciary is to make decisions with the consent of an adviser, then **except in cases of willful misconduct or gross negligence on the part of the fiduciary, the fiduciary shall not be liable** for any loss resulting directly or indirectly from any act taken or omitted as a result of such adviser’s failure to provide such consent after having been requested to do so by the fiduciary. 12 Del. C. § 3313(c).  
[emphasis added]

- (d) In all cases, there may be an adviser who is a “trust protector”.

#### Trust Protector

... the term “adviser” shall include a “protector” who shall have all of the power and authority granted to the protector by the terms of the governing instrument, which may include but shall not be limited to:

- (i) The power to remove and appoint trustees, advisers, trust committee members, and other protectors;
  - (ii) The power to modify or amend the governing instrument to achieve favorable tax status or to facilitate the efficient administration of the trust; and
  - (iii) The power to modify, expand, or restrict the terms of a power of appointment granted to a beneficiary by the governing instrument. 12 Del. C. § 3313(f).
- (e) The statutory protection afforded trustees of directed trusts would be diminished if advisers or beneficiaries could sue the trustee on the theory that the trustee had a duty to keep them informed and to impart to them knowledge affecting their interests in the trust so they could perform their duties as advisers or otherwise protect their beneficial interests in the Trust.

#### Duty to Monitor, Communicate and Inform

Whenever a governing instrument provides that a fiduciary is to follow the direction of an adviser with respect to investment decisions, distribution decisions, or other decisions of the

fiduciary, then, except to the extent that the governing instrument provides otherwise, **the fiduciary shall have no duty to:**

- (i) **monitor the conduct of the adviser;**
- (ii) **provide advice to the adviser or consult with the adviser; or**
- (iii) **communicate with or warn or apprise any beneficiary or third party concerning instances in which the fiduciary would or might have exercised the fiduciary's own discretion in a manner different from the manner directed by the adviser.** 12 Del. C. § 3313(e). [emphasis added]

\* \* \*

Absent clear and convincing evidence to the contrary, the actions of the fiduciary pertaining to matters within the scope of the adviser's authority (such as confirming that the adviser's directions have been carried out and recording and reporting actions taken at the adviser's direction), shall be presumed to be administrative actions taken by the fiduciary solely to allow the fiduciary to perform those duties assigned to the fiduciary under the governing instrument and such administrative actions shall not be deemed to constitute an undertaking by the fiduciary to monitor the adviser or otherwise participate in actions within the scope of the adviser's authority. Id.

- (f) Recognizing the multiple roles played by different fiduciaries of a Delaware trust, Delaware adopted 12 Del. C. § 3317 in 2010. The statute provides that, except as provided in the governing instrument, each trust fiduciary (including trustees, advisers, protectors, and other fiduciaries) have a duty to keep the other fiduciaries reasonably informed about the administration of the trust with respect to the specific duty or function being performed by that fiduciary. The statute further provides that a fiduciary who requests and receives such information has no duty to monitor the conduct of the other fiduciary, provide advice or consult with the other fiduciary or provide information or communicate or warn any beneficiary or third party concerning instances in which the fiduciary receiving the information would or might have exercised the fiduciary's own discretion in a different manner. 12 Del. C. § 3317. This provision specifically restates the principle that one fiduciary does not have a duty to monitor, communicate and inform as provided in 12 Del. C. § 3313(e).

D. Directed Trusts – The Language of the Trust Instrument. Once the statutory framework is in place, the focus shifts to the specific language of the trust instrument.

1. Trust Adviser Language. The particular adviser language included in the trust instrument depends upon the purpose for which the trust is created and the reason why the adviser is appointed. There are innumerable reasons why trustors create directed trusts and it would be impossible to include in this outline all of the language used over the years creating trusts with trust advisers. Most directed trusts do, however, fall into certain categories and the most common are illustrated below by examples with sample language listing the powers of various advisers in the appendix.

(a) Special Holdings Direction Adviser. Mr. and Mrs. Ipo started two software companies which have gone public, created three more which may or may not go public and invested in certain speculative land development companies building hotels and casinos in Las Vegas and elsewhere. They have four children. From the inception of their enterprises, they created one trust for each of their four children funded with investment assets that, at that time, had very little value. Each trust is presently worth \$30,000,000 and consists of ownership interest in each of the separate entities. Although there has been some diversification in each trust, it is minimal. Each trust now holds approximately \$10,000,000 of marketable assets, interests in the various real estate investment companies and interests in newly formed software companies that may or may not go public.

Mr. and Mrs. Ipo recognize that their talents are more technical and scientific and not at all financial. Throughout the development of the various businesses, they relied heavily on Ms. Business-Manager who presently serves as trustee of the four trusts. Ms. Business-Manager has no problem dealing with the privately held investments. However, she feels totally incapable of managing the \$40,000,000 of marketable investments - \$10,000,000 in each trust. No bank or trust company is willing to accept the trusts because of the high concentration of privately held investments. Mr. and Mrs. Ipo wish to keep Ms. Business-Manager handling the private investments and seek professional money management for the cash and marketable securities.

Answer. Mr. and Mrs. Ipo may designate a trustee in a jurisdiction that allows directed trusts. A routine court proceeding in the new situs will permit the court to confirm the appointment of the new trustee, accept jurisdiction over the trust, confirm that the law of

administration in the new situs will thereafter govern the administration of the trust and reform the trust to include a Special Holding Direction Adviser. Alternatively, it may be possible to utilize a decanting statute to “pour over” trust assets to a new trust with the appropriate directed trustee language. Thereafter, the trustee in the new situs will administer the trust and be responsible for investment of the marketable securities in each of the trusts. The old trustee will become a Special Holding Direction Adviser and will direct the new trustee with respect to all decisions affecting the special holdings: the land development companies and the new start up businesses. The new trustee will have no liability for the special holdings. The Special Holding Direction Adviser will have no liability for the investment of publicly traded assets. A sample Special Holding Direction Adviser form is included in the appendix. A typical statement of the role and function of the Special Holding Direction Adviser is included in the appendix.

- (b) Investment Direction Adviser. Mr. I. M. Rich formerly resided in New York and now resides in Florida. He has three children. He has a variety of different trusts he created for each of these children. He is also in the process of creating additional trusts for his children. He is concerned about the New York state income tax the trusts are being required to pay because the trustees reside in New York. He has been advised by his attorney to relocate the trusts to a jurisdiction that does not tax trust income or capital gain accumulated for future distribution to beneficiaries who do not reside in the new situs. He is willing to accept the advice of his counsel. However, he has developed a skilled network of financial managers who reside outside of New York and does not want to turn over the investment of all of the trust wealth to a new trustee simply to avail the trust of the income tax savings. Moreover, Mr. Rich is cheap. He does not want to pay the new trustee significant fees for holding trust assets that are being invested by others.

Answer: Mr. Rich can transfer the existing trusts and establish the new trusts in a jurisdiction that does not tax trust income or capital gains accumulated for nonresidents. The corporate trustee in the new situs will serve as an administrative trustee. All of the investment decisions will be made by Investment Direction Advisers in accordance with the terms of the new trust agreements or in accordance with judicial modification of the existing trust agreements when they are moved to the new situs. Once again, the judicial modification will confirm the appointment of the new trustee, accept jurisdiction over the trust, confirm that the law of administration in the new situs will thereafter govern the

administration of the trust and reform the trust. As noted, it may also be possible to use a state decanting statute to pour over the trust assets to a new trust with the appropriate directed trustee language. The new situs trustee will charge a flat annual fee of anywhere from \$3,500 on the low end to \$10,000 on the high end for serving as “purely administrative trustee”. The trusts will avoid state income tax on income and capital gain accumulated in the trust. A sample Investment Direction Adviser form is included in the appendix. A typical statement of the role and function of the Investment Direction Adviser is included in the appendix.

- (c) Consent Adviser. Mr. Johnson is the founder of a famous pharmaceutical company. He began his business in the basement of his home when his children were young and has watched the business grow to a publicly traded company. Along the way, he created many trusts for his family and has admonished all of his descendants never to sell any of the company stock. In the course of establishing trusts, Mr. Johnson had great difficulty locating a trustee who would accept trusts 90% of the corpus of which consisted of one company’s stock. The trustees pointed out cases where changes in technology and lawsuits for products liability substantially reduced the value of a company’s stock. They warned that, even though the company is doing well now, no one knows what the future will hold. They informed Mr. Johnson they have a duty to diversify trust investments. Mr. Johnson values the advice of the trustees, but wants to hold the trustees in check and prevent a “precipitous sell off” of the stock. He has close business associates and he wants them to have the final say on a recommendation to sell the stock.

Answer: Mr. Johnson can include language in his trust appointing a “Consent Adviser”. If the trustee determines that there is a “material change in the business prospects of the company” the trustee can make a recommendation to sell some or all of the company stock. However, the stock may not be sold by the trustee without the “written consent of the Consent Adviser”. The trustee will have no liability for its good faith reliance on the terms of the trust instrument and will only be liable for its willful misconduct or gross negligence. A sample Consent Adviser form is included in the appendix. A typical statement of the role and function of the Consent Adviser is included in the appendix.

- (d) Distribution Adviser. Mr. and Mrs. Dysfunctional have been phenomenally successful and have built huge family wealth. Unfortunately, they have four children, all of whom have drug and alcohol problems. They want to create a separate trust for each

child and prohibit income and principal distributions whenever “the trustee reasonably believes the beneficiary routinely or frequently uses or consumes any illegal drugs or other illegal chemical substances and is physically or psychologically dependent upon that drug or substance”. They want testing provisions and treatment provisions included in the trust document. They insist that, at any sign of dependency, the trustees “completely cut off” any distributions to or for the benefit of a child “no matter what”. Mr. and Mrs. Dysfunctional value the trustee’s investment expertise and trust management skills. However, the trustee is concerned that the Dysfunctional children will initiate litigation as soon as their parents are dead. Mr. and Mrs. Dysfunctional have brothers and sisters who are also wealthy and very sympathetic to the plight of the Dysfunctional children. The trustee wants to manage the trust fund but does not want liability for enforcing subjective, discretionary distribution provisions included in the trust instrument.

Answer: The trust instrument may include language appointing a “Distribution Adviser”. The Distribution Adviser can be given the power to direct, consent to, or disapprove any discretionary distributions of income or principal to or for the benefit of the Dysfunctional children. The trustee will have no liability to the trust beneficiaries for the trustee’s good faith reliance on the trust instrument and the decisions made by the Distribution Adviser. The children will be required to sue their uncles and aunts (the Distribution Advisers) if they disagree with the distribution decisions. A sample Distribution Adviser form is included in the appendix. A typical statement of the role and function of the Distribution Adviser is included in the appendix.

2. Regime Change Provision. Trust language appointing a trustee and establishing the roles of the Special Holding Direction Adviser, the Investment Direction Adviser, the Consent Adviser and the Distribution Adviser is only part of the picture. Circumstances change. Trust departments lose key personnel, advisers grow tired and old, the law of trust administration in the host jurisdiction may be modified and new tax laws may be passed. The appointment of a Trust Protector may be appropriate.

E. Statutory Framework for Trust Protectors. Some states treat Trust Protectors as just another kind of trust adviser. Others have statutorily recognized Trust Protectors and clearly define the additional powers Trust Protectors may have.

1. Trust Protectors as Advisors. Alabama, Maine, North Carolina, South Carolina and Tennessee have statutes recognizing trust advisers with the

“power to direct” trustees by comment to the statute that ratifies the use of Trust Protectors as advisers. Ala. Code 1975 § 19-3B-808; 18-B M.R.S.A. § 808; N.C.G.S.A. § 36 C-8-808; SCC § 62-7-808; T.C.A. § 35-15-808.

2. Statutory Recognition - Trust Protector. Alaska, Delaware, Idaho, South Dakota, Utah and Wyoming have statutes that specifically recognize the role of Trust Protector. AS 13.36.370; 12 Del. C. § 3313(f); I.C. § 15-7-501; SDCL § 55-1B-1; U.C.A. 1953 § 25-6-14; W.S. 1977 § 4-10-103. Most of the cited statutes define the Trust Protector as a “disinterested third party” who has the powers and discretions provided in the trust instrument which may include, but are not limited to, the following powers:

- (a) The power to remove and appoint a trustee, trust adviser, investment committee member or distribution committee member, Example: SDCL § 55-1B-6(4); 12 Del. C. § 3313(f)(1).
- (b) The power to modify or amend the trust instrument to achieve favorable tax status or to facilitate the efficient administration of the trust. Example: AS 13.36.370(b)(2); 12 Del. C. § 3313(f)(2); W.S. 1977 § 4-10-710(a)(i).
- (c) The power to increase or decrease the interest of trust beneficiaries. Example: I.C. § 15-7-501(6)(b).
- (d) The power to modify the terms of a power of appointment created under the trust instrument. Example: 12 Del. C. § 3313(f)(3); I.C. § 15-7-501(6)(c).

The Wyoming statute is the most comprehensive and, in addition to the foregoing powers, allows the Trust Protector to exercise the following additional powers pursuant to W.S. 1977 § 4-10-710(a).

- The power to appoint successor Trust Protectors.
- The power to review and approve accountings.
- The power to change the governing law or principal place of administration of the trust.
- The power to interpret the terms of the trust instrument at the request of the trustee.
- The power to advise the trustee on matters concerning any beneficiary.

- The power to direct, consent or disapprove a trustee’s action or inaction in making distributions to beneficiaries.
3. Trustee Liability. A trustee is not liable for any loss resulting from any action or inaction upon the direction of the Trust Protector. Examples: I.C. § 15-7-501(5); SDCL § 55-1B-5; W.S. 1977 § 4-10-717.
  4. Trust Protector - The Language of the Trust. Whether the Trust Protector is merely a different kind of trust adviser with broader powers over the trust or a statutorily recognized person with statutory powers, the scope of the Trust Protector’s authority over the trustee, the trust advisers, the trust beneficiaries, the trust investments and indeed the very terms of the trust instrument will itself turn on the language of the trust. A typical statement of the role and function of a trust protector is included in the appendix.
- F. Definition. Purely administrative trustees provide very limited trust services. Their sole purpose is to allow the trust over which they serve to utilize the favorable trust laws of their jurisdiction. Example: A wealthy New York resident wishes to create a perpetual trust in Delaware with marketable securities for tax purposes. The trustor already has a sophisticated team of financial planners and investment advisers. The trustor creates a Delaware limited liability company (“LLC”) to which he transfers marketable securities. The trustor then creates a Delaware dynasty trust naming a Delaware trustee as a Purely Administrative Trustee. The only asset held by the Delaware trustee is the LLC units. The language of the trust instrument includes a Special Holding Direction Adviser to direct the trustee with respect to all matters concerning the LLC units held in trust. Because the trust may one day hold investment assets, the trust is a directed trust with an Investment Direction Adviser named to direct the trustee with respect to all matters concerning trust investments. There is a Distribution Adviser to direct the trustee with regard to trust distributions. A Trust Protector provision is included allowing the Trust Protector to remove and replace the trustee, the Special Holding Direction Adviser, the Investment Direction Adviser and the Distribution Adviser. The Trust Protector may also change the situs of the trust and modify the language of the trust instrument to obtain favorable tax treatment or facilitate the administration of the trust.
1. Administrative Trustee Duties. The only duties performed by the Administrative Trustee are to hold the LLC units, maintain trust records, prepare or otherwise arrange for the preparation of fiduciary income tax returns and maintain an office for its business in the state. The trustee has no liability for actions taken or not taken by the Special Holding Direction Adviser, the Investment Direction Adviser, the Distribution Adviser and the Trust Protector absent the trustee’s willful misconduct.

G. Trustee Fees. Administrative trustees, recognizing the limited role they play, offer low fees for trust services and look for a volume business to produce revenues for the trust company. Typically, administrative trustees will serve for annual fees of anywhere from \$3,500 to \$10,000 per trust. To illustrate the fee structure, below are actual fee quotes from two Delaware trust companies for providing trust services in different capacities for a trust with assets valued at \$7.5 million.

Bank I

1. Where we hold only an LLC interest, our fee is \$5,000 per year.
2. Where we hold liquid assets, subject to direction on investments, our fee is \$24,000 per year.
3. Where we hold liquid assets, but have full discretion as to investments, our fee is \$77,000 per year.

Bank II

1. Bank II is hired as trustee. Under this scenario, there is no direction adviser. Bank II is trustee and manages the investment portfolio at its discretion, subject to the terms of the trust document. The fee schedule is as follows:

<u>Fee Schedule</u>	<u>Rate</u>	<u>Balance</u>	<u>Fee</u>
First \$2,000,000 of principal value	0.500%	\$2,000,000	\$10,000
Next \$3,000,000	0.375%	3,000,000	11,250
Next \$5,000,000 of principal value	0.350%	<u>2,500,000</u>	<u>6,250</u>
<b>Total</b>		<b>\$7,500,000</b>	<b>\$27,500</b>

2. Bank II is hired as trustee. The trust holds LLC units only and Bank II, the administrative trustee, is directed to hold the LLC units in the trust.

\$6,000 for the first \$10 MM of assets held in the LLC

\$10,000 for assets valued between \$10 MM and \$20 MM in the LLC.

H. Fully Directed Trusts. Purely administrative trustees evolved from the carefully crafted language of trust instruments that define the duties and responsibilities of various advisers to the trust. The combination of Direction Advisers and

Distributions Advisers coupled with the power of the Trust Protector resulted in the development of a trust concept where the formerly fully responsible corporate trustee now serves only in an administrative capacity while all of the duties and responsibilities traditionally vested in the corporate trustee rest now in the hands of advisers and protectors to the trust. A sample Administrative Trustee form is included in the appendix. A typical statement of the role and function of the Administrative Trustee is included in the appendix.

I. Liability Issues. Can directed trusts protect fiduciaries from liability? Will the statutory framework previously discussed and the language of the trust instrument really work? This author is aware of only two state court decisions on the matter to date: One is a Delaware decision and the other is a Virginia decision. Both involve Investment Direction Advisers.

1. The Delaware Decision. In *Duemler v Wilmington Trust Co.*, C.A. No. 20033 N.C. (Del. Ch. 2004), the corporate trustee was sued by an individual co-trustee who was the sole Investment Direction Adviser of a trust established by his family. The Investment Direction Adviser chose not to tender a bond owned by the trust when he had the option to do so. The issuer of the bond defaulted and the Investment Direction Adviser sued the corporate trustee alleging the corporate trustee breached its fiduciary duty to the trust by, among other things, failing to provide the Investment Direction Adviser with appropriate financial information to allow the Investment Direction Adviser to make an informed decision. The case was litigated in the Delaware Court of Chancery.

(a) The Ruling. The Court decision is not reported. The Court was so certain of the proper outcome of the case that it ruled from the bench. A copy of the transcript of the decision may be obtained by email request to [mgordon@gfmlaw.com](mailto:mgordon@gfmlaw.com). Relevant quotes are set forth below.

THE COURT: I'm in a position to rule. I'm not going to require that the parties expend additional resources on this. The matter is abundantly clear to me. (Tr. P. 3, L. 2-5).

\* \* \*

...Mr. Duemler was the investment adviser for a high-risk approach to investing of particular - of assets under a particular trust. Had he wished for Wilmington Trust to be investment advisor to run a high-risk portfolio - I'm sure Wilmington Trust likes to make money. It would be willing to do it. It costs a lot more. (Tr. P. 3, L. 10-16).

Finding that the trust held “a nondiversified portfolio with extremely risky assets” (Tr. P. 11, L. 22-23), the court stated: I think in terms of the division of trust responsibilities, it was absolutely clear that this was on Mr. Duemler’s side of the ledger. (Tr. P. 12, 9-11).

The Court held that the proximate cause of the loss was “the breach of fiduciary duty by Mr. Duemler” who had the primary responsibility for being the investment adviser. (Tr. P. 13, L. 4-13).

- (b) Significance of the Decision. The Court upheld the statutory defense under 12 Del. C. § 3313(b) (Delaware’s directed trust statute) and noted that the case was “an apt instance for its application” because there was “absolutely no evidence of willful misconduct” on the part of Wilmington Trust Company. (Tr. P. 15, L. 12-16). Moreover, the court admonished the investment direction adviser for arguing that the trustee was responsible for failure to provide relevant information. The court stated: And you don’t get to come in and hang your fellow fiduciary on that unless they engaged in willful misconduct. There is none there. And if I were to rule that, ‘oh, no. What the problem is here is the failure to provide information or to make sure that the fiduciary making the decision knew what they were doing,’ I think that would gut the statute. (Tr. P. 16, L. 5-12).

The court’s clear recognition of the intent and purpose of the directed trust statute and its firm ruling upholding the statute is a clear indication that Delaware courts will enforce directed adviser provisions in a trust instrument based on the statutory framework that permits them.

2. The Virginia Decision. In *Rollins v Branch Banking and Trust Company of Virginia*, 2001 W.L. 34037931 (Va. Cir. Ct.), the plaintiffs were children and grandchildren of the grantors of two trusts created in 1977 for their benefit. The plaintiffs were suing the corporate trustee for breach of fiduciary duty, in particular, the trustee’s failure to diversify trust investments. The trusts were funded primarily with shares of stock in two textile corporations. At the inception of the trusts, the trustee “obtained the written authority of the beneficiaries to over-concentrate the trust” with textile stocks. *Rollins*, at \*1. The trust remained over concentrated in the textile stock until 1997 (20 years later) when the stock was sold. The beneficiaries sued the trustee for \$25 million, the amount they claim they lost due to the trustee’s failure to diversify the trust investments. The trustee, citing the Virginia directed trust statute, filed the equivalent of a motion for summary judgment contending that

when, as here, the trust vests the power to make investment decision exclusively in persons other than the trustee, the trustee cannot be liable for the loss resulting from the retention of the investment. *Rollins*, at \*2.

- (a) The Ruling. The court ruled in favor of the corporate trustee citing the Virginia directed trust statute and quoting the specific language of the trust instrument. The Virginia trust statute (which has since been changed to a version closer to the UTC provision) then provided:

§ 26-5.2. Liability of a fiduciary for actions of cofiduciary C. Whenever the instrument under which a fiduciary or fiduciaries are acting reserves unto the trustor, testator, or creator or vests in an advisory or investment committee or any other person or persons, including a cofiduciary, to the exclusion of one or more of the fiduciaries, authority to direct the making or retention of investments, or any investment, the excluded fiduciary or cofiduciary shall be liable, if at all, only as a ministerial agent and shall not be liable as fiduciary or cofiduciary for any loss resulting from the making or retention of any investment pursuant to such authorized direction. Va. Code § 26-5.2.

The court found that: “The trustee’s power to diversify, however, was limited by the express language of Article X of the trust instruments” which stated “investment decisions as to the retention, sale, or purchase of any asset of the Trust Fund shall likewise be decided by such living children or beneficiaries, as the case may be”. *Rollins*, \*2.

- (b) Significance of the Decision. Like *Duemler*, the plaintiffs in *Rollins* argued that the trustee had a duty to keep them informed and to impart to them any knowledge affecting their interest in the trust. *Rollins* at \*4. However, the court was not persuaded:

The plain language of the instrument, however, clearly contradicts the beneficiaries’ argument. The beneficiaries, alone, had the power to make investment decisions. **The statute enacted by the General Assembly recognizes the basic principal (sic) that the court cannot hold a trustee, or anyone else, liable for decisions that it did not and could not have made.** The statute clearly applies in this instance and the beneficiaries have not stated a cause of action against the trustee for failing to diversify the trust assets. The demurrer is granted as it relates to all claims for failure to diversify. *Rollins*, at \*2. [emphasis added]

The court's clear recognition of the intent and purpose of the directed trust statute and its firm ruling upholding the statute is a clear indication that Virginia courts will enforce directed adviser provisions in a trust instrument based on the statutory framework that permits them.

3. Trust Protector - Case Law. Perhaps because the concept of trust protector is so new in the United States or because cases are settled or are otherwise disposed of, there appear to be no reported decisions dealing with the subject of fiduciary liability for an administrative trustee following the direction of a Trust Protector. There have been at least two Trust Protector cases in Delaware in which the author's law firm was involved. One case is a matter of public record. The other was sealed by the court during the proceedings to protect the privacy of the parties.\*2.

- (a) The Friedman Case. In *Friedman v. U.S. Trust Company of Delaware*, C.A. No. 20205 NC (2003 Del. Ch.), an elderly California resident was the beneficiary of a credit shelter trust established in 1970 by his late wife. He was about to marry for the fifth time. All of the residuary trust assets were held in more than 25 limited liability companies. The resident's son persuaded his father to move the residuary trust to Delaware "for asset protection purposes" prior to the marriage. U.S. Trust Company of Delaware agreed to serve as administrative trustee. A routine proceeding was conducted in the Court of Chancery to have Delaware accept jurisdiction over the trust, recognize U.S. Trust Company of Delaware as the trustee, declare that Delaware would thereafter govern the administration of the trust and modify the trust to include direction adviser provisions including the appointment of the son as a Trust Protector. The father resigned as trustee of the residuary trust. The father and son had a falling out. The son informed the father that the son, as Trust Protector, was now in charge of all of the business assets held in the 25 limited liability companies. When the father realized he had lost control of the residuary trust assets, he filed suit in Delaware seeking to open the judgment transferring the trust situs and appointing the son as Trust Protector. The reformed trust document defined the role of the Trust Protector as follows:

The Trustee shall not exercise any of its rights, powers or privileges under the Trust, or take any action under the Trust ...except upon written direction of the Trust Protector.

- (b) The Ruling. The court was deeply concerned with certain procedural matters. In particular, no notice of the change of situs of the trust had been given to the father's other three children who

were remainder beneficiaries of the trust. The court also struggled with the concept of a purely administrative trustee and the role of the Trust Protector as evidenced by the following excerpt from the transcript of a hearing before the court.

The Court: Trust Protector... sounds like a super hero, or something like that. Is that something under California law that's developed as a concept? ...Why do we need a trustee when you have the omnipotent-

Attorney: In this case, that's a good question. Virtually all of the powers are vested in [the son], as Trust Protector.

\* \* \*

The Court then questioned the attorney for the Trust Company to determine how the father lost control of the trust assets in the process.

Trust Co.: We simply did not have any knowledge of those facts that created this. My client was a facilitator. And under these instruments, if they are to govern, we are Administrative Trustee... that's our limited role. We are at the direction of the Trust Protector.

The Court: You are not really - - you are almost a pure Administrative Trustee. Right?

Trust Co.: I would say we are a pure Administrative Trustee.

The Court: Not even a money managing trustee, or anything like that.

Trust Co.: That's correct.

Immediately following the hearing, the court opened and vacated the order appointing the son as Trust Protector and the trust company as Administrative Trustee. The action was stayed pending further proceedings. In the interim, the parties agreed to litigate their dispute in California where the trust had been administered for more than thirty years.

- (c) Significance of the Outcome. The court did not assess any liability against the corporate fiduciary and all of the corporate fiduciary's legal fees were paid by the trust.

4. Sealed Case. Little can be said about the second Delaware case involving a Trust Protector. The case is under seal. However, it involved an offshore asset protection trust moved to Delaware pursuant to the Delaware Qualified Dispositions in Trust Act by a Trust Protector. It was alleged that the beneficiary of the trust suffered from mental illness and the Trust Protector essentially directed the Delaware Administrative Trustee not to make any distribution to or for the benefit of the beneficiary who the Trust Protector viewed as uncooperative. The beneficiary petitioned the Delaware court, which had jurisdiction over the Delaware Administrative Trustee, for the payment of approximately \$7,000 in certain past due bills and a stipend of only \$4,000 per month from a trust with a corpus that exceeded \$1 million.

(a) The Ruling. The corporate fiduciary took the position that it could not make any distributions from the trust except upon direction of the Trust Protector. There was hostility between the Trust Protector and the trust beneficiary. The court urged the parties to resolve their differences by stipulation. At one point the court wrote:

Dear counsel:

My in-box gives me an inclination that rationality might not be prevailing in this matter.

At the urging of the court, the parties entered into a stipulated settlement paying the beneficiary's delinquent bills and establishing a \$4,000 monthly living allowance. It was stipulated that the Trust Protector would resign (as would the Delaware corporate fiduciary) and the trust would be transferred back to the offshore jurisdiction from which it came

(b) Significance of the Outcome. No liability was assessed against the corporate fiduciary who served as a purely administrative trustee. All of the corporate fiduciary's legal fees were paid by the trust.

## V. MODIFYING AN IRREVOCABLE TRUST IN DELAWARE

There are two ways that an Irrevocable Trust may be modified under Delaware law: (1) through a judicial reformation; and (2) through the use of Delaware's decanting statute (12 Del. C. § 3828).

A. Consent Petitions. The Delaware Court of Chancery has worked closely with the Delaware Bar Association to allow "Consent Petitions" for purposes of reforming irrevocable trusts. If all parties interested in the trust agree (or for tax reasons state their non-objection or take no position) the trust may be reformed for a proper purpose. Included in the appendix is a copy of the Standing Order entered

by the Delaware Court of Chancery on June 2, 2010 setting forth the procedure for filing Consent Petitions for trust matters with the Register in Chancery. All Consent Petitions are filed in the Court of Chancery as Civil Miscellaneous Matters (C.M.) and are not matters of public record even absent a Court Order sealing the record.

- B. Requirements for Filing Consent Petitions. There are several requirements for filing Consent Petitions with the Register in Chancery relating to trust matters:
1. The Petitioner can be anyone with an interest in the trust such as a beneficiary or a fiduciary.
  2. The Petition must be accompanied by an explanatory cover letter from the filing attorney stating the material purpose of the Petition and summarizing the relief requested in the Petition.
  3. The Petition must have attached to it as an exhibit a copy of the trust instrument, amendments thereto and any Orders relating to the trust instrument.
  4. Unless the relationship of those with a beneficial interest in the trust to the grantor is self-evident, the filing attorney must enclose with the cover letter accompanying the Petition or attached as an exhibit to the Petition a family tree or other document showing the relationship of those having a beneficial interest in the trust to the grantor.
  5. The Petition must include, as exhibits, consents, notice of non-objection or statements of no position (“Consents”) to the relief requested in the Petition from all interested parties. This may include, but it is not limited to (i) trustees and other fiduciaries (unless they have otherwise signified their consent to the Petition by acting as a Petitioner or accepting a fiduciary position); (ii) the trust beneficiaries; (iii) all other persons having an interest in the trust pursuant to the express terms of the trust instrument (such as, but not limited to, power holders and persons having other rights and powers, held in a non-fiduciary capacity, with respect to trust property).
  6. For purposes of filing Consent Petitions, trust beneficiaries are defined as those with a present interest in the trust and those whose interest in the trust would vest, without regard to the exercise or non-exercise of a power of appointment, if the present interest in the trust terminated on the date the Petition is filed.
  7. A trust beneficiary’s Consent must be executed by (i) the beneficiary personally; (ii) the beneficiary’s attorney ad litem; (iii) a person authorized to virtually represent the beneficiary pursuant to 12 Del. C. § 3547 or any

successor statute; or (iv) a person authorized by applicable law to represent the beneficiary with respect to the Petition (such as, but not limited to, the beneficiary's attorney-in-fact or the Attorney General in the case of certain charitable beneficiaries).

8. Consents executed pursuant to 12 Del. C. § 3547 (Delaware's virtual representation statute) must include reference to the statute, state the relationship of the person signing the Consent to those virtually represented and include in the signature block the name of the person signing the Consent and the class of those virtually represented.
9. All Consents must be notarized unless there is justifiable cause why the Consent cannot be notarized and the Court waives the requirement.
10. All Consents must have a signature line with the name of the individual signing the Consent typed or printed below the signature.

C. Delaware's Decanting Statute. Delaware law authorizes a trustee that has authority under the terms of the trust instrument (the first trust) to invade principal for the benefit of one or more beneficiaries, to exercise such authority by appointing all or a portion of the principal subject to the power of invasion in favor of a trustee under a separate instrument (a second trust). 12 Del. C. § 3528(a). Implicit in the statute is the concept that, if a trustee may invade principal for a beneficiary under the terms of the trust agreement, the trustee may, in the exercise of its principal invasion power, appoint the principal to a new trust for the benefit of some or all of the beneficiaries of the first trust.

D. Requirements for Use of Delaware's Decanting Statute. There are several requirements that must be satisfied in order to utilize Delaware's decanting statute:

1. The trust instrument must not prohibit the trustee from distributing assets in further trust for a beneficiary. 12 Del. C. § 3528(a).
2. The trustee must have the ability to invade principal for the benefit of one or more of the beneficiaries of the trust. 12 Del. C. § 3528(a).
3. The beneficiaries of the second trust must also be beneficiaries of the first trust. 12 Del. C. § 3528(a)(1).
4. The second trust may not alter the beneficial interests of beneficiaries of the first trust that are not proper objects of the exercise of the power of invasion. 12 Del. C. § 3528(a)(1).
5. The second trust must comply with any standard that limits the trustee's authority to make distributions from the first trust (i.e., if the first trust

provides that distributions to the beneficiaries can only be made pursuant to an ascertainable standard the second trust cannot provide that distributions can be made to the beneficiaries for any purpose). 12 Del. C. § 3528(a)(5).

6. Delaware law must govern the administration of the first trust.
  7. A written “decanting instrument” must be signed and acknowledged by the trustee and filed with the records of the trust. 12 Del. C. § 3528(b).
- E. Other Aspects of Delaware’s Decanting Statute. Unlike Consent Petitions, the trustee does not need the consent of the beneficiaries or any other interested party to exercise its decanting power. However, it is common practice in Delaware to have the beneficiaries consent to the decanting and release and indemnify the trustee from any liability in connection with the decanting. While the second trust may not have beneficiaries who are not also beneficiaries of the first trust, the decanting statute specifically permits the second trust to grant a beneficiary of the first trust a limited or general power of appointment thereby allowing the beneficiary to appoint trust property to a person who is not a beneficiary of the first trust. 12 Del. C. § 3528(a). A trustee’s exercise of its decanting power is considered the exercise of a power of appointment and is subject to the provisions of Chapter 5 of Title 25 of the Delaware Code relating to the time at which the permissible period of the rule against perpetuities begins and the law which determines the permissible period of the rule against perpetuities. 12 Del. C. § 3528(c).
- F. Common Reformation Accomplished Through Consent Petitions and/or Decanting. Common reformation accomplished through Consent Petitions and/or decanting include:
1. Acceptance of jurisdiction over a trust so that Delaware is the situs of the trust and reformation of the trust so that Delaware law will thereafter govern the administration of the trust.
  2. Ratification of prior trust acts by trustees and other advisors.
  3. Bifurcation of trustee responsibilities through the appointment of advisers in accordance with 12 Del. C. § 3313 (i.e., Investment Direction Advisers, Distribution Advisers and Trust Protectors).
  4. Modification of other administrative provisions of a trust (i.e., succession of trustee provisions, accounting provisions, trustee powers, etc.).
  5. Modification to beneficial terms of trust (i.e., removing beneficiary withdrawal rights at certain ages so trust assets stay in further trust for beneficiary’s lifetime as opposed to being distributed at specified ages).

6. Conversion of grantor trust to non-grantor trust for income tax purposes.
7. Division of a pot trust into separate trusts for the benefit of a sole beneficiary.
8. Correction of mistake or ambiguity contained in trust agreement.

## VI. CREATING A DELAWARE TRUST

- A. New Trusts. It is self evident that a person who resides in another jurisdiction may take advantage of Delaware law by creating a new trust with a Delaware trustee incorporating the desired provisions of Delaware law. Typically, Delaware counsel will not work directly with an individual non-resident for this purpose and will insist on coordinating with the non-resident's local counsel so the new trust will be part of the overall non-resident's estate plan.
- B. Existing Irrevocable Trusts. The more intriguing question is whether existing irrevocable trusts can be modified to take advantage of Delaware law.
  1. In cases where the existing trust is drafted with flexible provisions that allow a change of situs, the removal of one trustee and the appointment of a successor trustee and include a Trust Protector or other provision that allows a person, not related or subordinate to the trustor under Internal Revenue Code § 672(c), to modify or amend the trust instrument to facilitate the efficient administration of the trust, the existing trust situs may be changed and the trust may be reformed to add direction provisions or any other provisions of Delaware law desired without court intervention.
  2. When the trust language is not flexible, it is still possible to change the situs of an existing trust to Delaware and to modify the trust language to take advantage of the provisions of Delaware law using one of two techniques.
    - (a) First, the trust may be reformed through a proceeding in the Court of Chancery. These proceedings require a petition to be filed in Delaware. The petition seeks an order from the Court of Chancery that (i) confirms the appointment of the Delaware trustee (often an affiliate of the existing corporate fiduciary that now has established an office in Delaware), (ii) accepts jurisdiction over the trust, (iii) confirms that the law of administration of the State of Delaware will thereafter govern the trust administration, and (iv) reforms the trust to avail it of the various favorable administrative provisions of Delaware law including provisions that allow the trust to become a directed trust. These petitions are typically filed in

Delaware as “consent petitions”. A copy of the standing order of the Court of Chancery of the State of Delaware setting forth the procedure for filing consent petitions for trust matters is included in the appendix. Essentially, if all current beneficiaries of the trust and those who would take if the trust terminated without regard to the exercise or non-exercise of a power of appointment waive notice of the proceeding and consent to the relief requested in the petition the court will enter an order. In tax sensitive cases, it is typical to file a receipt of notice and non-objection instrument in lieu of a consent.

(b) A second technique that has recently become more popular involves decanting. When a trust’s jurisdiction such as Delaware has a decanting statute and it is possible to appoint a trustee in Delaware, the Delaware trustee, without court proceedings, may decant the trust assets of a trust into a new trust that contains the appropriate administrative provisions desired.

C. Result. The result is that a new trust with a particular reason to take advantage of provisions of Delaware law may be established as a Delaware trust in the first instance and an irrevocable trust may be easily moved to Delaware and be modified or decanted to include the desired provisions of Delaware law. Out of state trustors can retain their network of investment advisers and professionals and continue their relationship with their local trust attorney while availing themselves of favorable provisions of Delaware law and, in the process, negotiate a fee with a Delaware trustee that is appropriate given the services to be performed by the Delaware trustee.

## VII. CONCLUSION

So, why is everyone talking about Delaware trusts. Because Delaware has favorable trust law and you do not have to live in Delaware or work in Delaware to take advantage of the Delaware trust statutes. The directed trust provisions of Delaware trust law permit anyone to establish a Delaware and continue to maintain existing professional relationships outside the state. Whether Delaware trust law offers advantages to you or your clients is a matter of professional judgment. All you need to know is the advantages of Delaware trust law to determine whether it is appropriate for a trust to have its situs in Delaware with either a full trust administration or under a more economical, purely administrative trustee arrangement. Hopefully this outline will make it easy for you to decide.

# EXHIBIT A

## Role and Function Provisions of Various Advisory Positions for Delaware Trusts

### A. Investment Direction Adviser

Role and Function. The Investment Direction Adviser shall hold and exercise the full power to manage the investments of the Trust, including, but not limited to, the power to purchase, sell and retain all of the Trust assets, and the power to exercise voting, subscription, conversion, option and similar rights with respect to such property and to participate in and consent to any voting trust, reorganization, merger, dissolution or other action affecting any such property. The Trustee shall follow the direction of the Investment Direction Adviser with respect to all matters relating to the management and investment of Trust assets. In the event no Investment Direction Adviser is then serving, the Trustee shall hold and exercise the full power to manage and invest the Trust assets.

### B. Distribution Adviser

Role and Function. The Distribution Adviser shall hold and exercise the full power to direct the Trustee to distribute income and principal of the Trust pursuant to the standards established under this Agreement. The Trustee shall follow the direction of the Distribution Adviser with respect to all matters concerning the distribution of income or principal of the Trust. In the event no Distribution Adviser is then serving, the Trustee shall hold and exercise the full power to make discretionary distributions of income and principal of the Trust pursuant to the standards established under this Agreement.

### C. Trust Protector

Role and Function. The Trust Protector shall have the following roles, powers and duties:

- (1) To amend the administrative and technical provisions with respect to any trust created by or pursuant to this Agreement at such times as the Trust Protector may deem appropriate for the proper administration of the Trust and for tax purposes in accordance with the provisions of Article \_\_\_\_\_ of this Agreement.
- (2) To designate the law of any jurisdiction (under which the terms of any trust created by or pursuant to this Agreement shall be capable of taking effect) to be the governing law of any trust created by or pursuant to this Agreement, in accordance with Article \_\_\_\_\_ of this Agreement.
- (3) To remove and replace the Trustee as provided in Article \_\_\_\_\_ of this Agreement, at any time and from time to time, with or without cause.

- (4) To remove any Investment Direction Adviser, at any time and from time to time, with or without cause, and to appoint additional and successor Investment Direction Advisers as provided in Article \_\_\_\_\_ of this Agreement.
- (5) To remove any Distribution Adviser, at any time and from time to time, with or without cause, and to appoint additional and successor Distribution Advisers as provided in Article \_\_\_\_\_ of this Agreement.
- (6) To appoint additional and successor Trust Protectors as provided in this Article \_\_\_\_\_.
- (7) To appoint a Special Fiduciary in accordance with Article \_\_\_\_\_ of this Agreement.
- (8) To enter into fee agreements with the Trustee, the Investment Direction Adviser and the Distribution Adviser.

**D. Special Holding Direction Adviser**

Role and Function. The Special Holding Direction Adviser shall hold and exercise the full power to manage the Special Holdings, including, but not limited to, the power to purchase, sell and retain all of the Special Holdings, and the power to exercise voting, subscription, conversion, option and similar rights with respect to Special Holdings and to participate in and consent to any voting trust, reorganization, merger, dissolution or other action affecting any Special Holdings. The Trustee shall follow the direction of the Special Holding Direction Adviser with respect to all matters relating to the management and investment of the Special Holdings.

**E. Administrative Trustee**

In the event that a corporate Trustee, is serving as Trustee of any trust created by or pursuant to this Agreement, and there is an Investment Direction Adviser, a Distribution Adviser and/or Trust Protector serving pursuant to Articles \_\_\_\_\_, \_\_\_\_\_ and \_\_\_\_\_ of this Agreement, any corporate Trustee shall exercise all of its powers hereunder, except to the extent otherwise expressly provided in this Article, solely at the written direction of the acting Investment Direction Adviser, the Distribution Adviser and/or Trust Protector (the “Advisers”) in accordance with the provisions of this Agreement.

- (1) Administrative Duties of Trustee. The Trustee shall have the following exclusive administrative duties, which shall, subject to the provisions of Article \_\_\_\_\_ of this Agreement, all be performed by the Trustee in the Trustee’s sole discretion and not at the direction of the Advisers:
  - (a) To maintain an account or accounts for the purpose of the custody and safekeeping of the Trust assets, receiving trust income and contributions

and from which trust expenditures (not including compensation paid to outside custodians, money managers, investment managers or other investment consultants) and distributions are disbursed.

- (b) To maintain storage of tangible personalty and evidence of intangible Trust property.
- (c) To maintain Trust records and to originate, facilitate and review Trust accountings, reports and other communications with the Notice Recipients, the Advisers and unrelated third parties, except that the Administrative Trustee shall not be responsible for the accuracy of information provided to the Administrative Trustee by any third party pursuant to an agreement into which the Advisers have directed the Administrative Trustee to enter.
- (d) To maintain an office for Trustee meetings and other Trust business.
- (e) To respond to inquiries concerning any trust created hereunder from the Notice Recipients, the Advisers, and unrelated third parties.
- (f) To execute documents in connection with the performance of its duties under this Article.
- (g) To retain accountants, attorneys, agents and other advisers in connection with the performance of the Trustee's administrative duties.
- (h) To prepare and file income tax returns for the Trust.

## **EXHIBIT B**

### **CREATING A DELAWARE ASSET PROTECTION TRUST**

Peter S. Gordon, Esquire  
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What follows is a summary of the relevant issues to consider when drafting a Delaware asset protection trust under the Qualified Dispositions In Trust Act, 12 Del. C. § 3570, et seq., (the “Act”). Included are the requirements for creating a trust (a Delaware asset protection trust) under the Act, prohibited powers which the grantor may not retain under the Act, permissible powers which the grantor may retain under the Act, who may defeat a Delaware asset protection trust and some income tax considerations.

**A. Requirements To Create A Delaware Asset Protection Trust.**

There are six requirements to create a Delaware asset protection trust under the Act. These requirements are as follows:

- (1) A disposition by a transferor by means of a trust instrument. 12 Del. C. § 3570(7).
- (2) The trust instrument must appoint a qualified trustee within the meaning of 12 Del. C. § 3570(8). 12 Del. C. § 3570(11).
- (3) The qualified trustee must maintain or arrange for custody in Delaware of at least some of the trust assets, maintain records for the trust on an exclusive or non-exclusive basis, prepare or arrange for the preparation of fiduciary income tax returns for the trust or otherwise materially participate in the administration of the trust. 12 Del. C. § 3570(8)b.
- (4) The trust must provide that Delaware law governs the validity, construction and administration of the trust. 12 Del. C. § 3570(11)a.
- (5) The trust must be irrevocable. 12 Del. C. § 3570(11)b.
- (6) The trust must contain a spend-thrift clause which should make reference to the Bankruptcy Code. 12 Del. C. § 3570(11)c.

**B. Prohibited Grantor Powers.**

There are several powers that are impermissible for the grantor to retain under the Act. These powers include:

- (1) The grantor may not serve as trustee of the trust. 12 Del. C. § 3570(8)a. & (8)c.
- (2) The grantor may not serve in an advisory position (including as a trust protector or distribution adviser) provided the grantor may serve as investment adviser for the trust. 12 Del. C. § 3570(8)d. & 12 Del. C. § 3571.

- (3) The grantor may not retain the power to direct distributions from the trust. 12 Del. C. § 3570(8)d. & 12 Del. C. § 3571.
- (4) The grantor may not demand a return of assets transferred to the trust. 12 Del. C. § 3571.

**C. Permissible Powers Retained by Grantor.**

The Act permits the grantor to retain a variety of powers. These powers include:

- (1) The grantor may serve as investment adviser for the trust and as such retain the right to consent to or direct investment decisions. 12 Del. C. § 3570(8)d.
- (2) The grantor may retain the power to veto distributions of income or principal from the trust. 12 Del. C. § 3570(11)b.1.
- (3) The grantor may appoint advisers who have authority to remove and appoint qualified trustees or trust advisers, advisers who have authority to direct, consent to or disapprove distributions from the trust and advisers described in 12 Del. C. § 3313. 12 Del. C. § 3570(8)c.
- (4) The grantor may retain the power to remove and replace trustees or trust advisers. 12 Del. C. § 3570(11)b.7.
- (5) The grantor may retain a limited power of appointment exercisable by will or other written instrument effective upon the grantor's death. 12 Del. C. § 3570(11)b.2.
- (6) The grantor may retain the ability to receive income or principal pursuant to broad discretion or a standard as determined by Delaware trustees, non-Delaware trustees and/or advisers. 12 Del. C. § 3570(11)b.6.
- (7) The grantor may retain the right to receive mandatory income distributions. 12 Del. C. § 3570(11)b.3.
- (8) The grantor may retain an interest in a CRT or a QPRT. 12 Del. C. § 3570(11)b.4.
- (9) The grantor may receive up to a 5% interest in GRAT, GRUT or total-return unitrust. 12 Del. C. § 3570(11)b.5.
- (10) The grantor may retain the potential or actual use of real property held under a qualified personal residence trust or the possession and enjoyment of a qualified annuity interest within the meaning of Treasury Regulations § 25.2702-5(c)(8). 12 Del. C. § 3570(11)b.8.
- (11) The grantor may retain the right to receive income or principal from the trust to pay income taxes due on the income of the trust provided that the trust instrument

expressly provides for the payment of such taxes and the potential or actual receipt of income or principal would be at the trustee's discretion, or pursuant to a mandatory direction in the trust instrument, or the discretion of an adviser. 12 Del. C. § 3570(11)b.9.

- (12) The grantor may retain the right to receive income or principal from the trust to pay, after the death of the grantor, all or any part of the debts of the grantor outstanding at the time of the grantor's death, the expenses of administering the grantor's estate, or any estate or inheritance tax imposed on or with respect to the grantor's estate. 12 Del. C. § 3570(11)b.10.

#### **D. Who May Defeat An Asset Protection Trust.**

There are four categories of creditors who may defeat a Delaware asset protection trust and as such reach the trust assets to satisfy a judgment. The Act requires that any action involving a Delaware asset protection trust be brought in the Delaware Court of Chancery. 12 Del. C. § 3572(a). The following four categories of creditors may defeat a Delaware asset protection trust:

- (1) A creditor whose claim arose before the creation of the trust provided the claim is brought within four years after the creation of the trust or, if later, within one year after the creditor discovered (or should have discovered) the trust and the claim is proven, by clear and convincing evidence, that the creation of the trust was a fraudulent transfer. 12 Del. C. § 3572(b)(1).
- (2) A creditor whose claim arose after the creation of the trust provided the claim is brought within four years after the creation of the trust and the creditor proves, by clear and convincing evidence, that the creation of the trust was a fraudulent transfer. 12 Del. C. § 3572(b)(2).
- (3) A person whose claim results on account of an agreement or court order for the payment of support or alimony for the grantor's spouse, former spouse or children, or for a division or distribution of property in favor of the grantor's spouse or former spouse. 12 Del. C. § 3573(1). Only a spouse who is married to the grantor before the trust was created may avail himself or herself of such right. 12 Del. C. § 3570(9).
- (4) A person who suffers death, personal injury or property damage on or before the date the trust was created for which the grantor is liable. 12 Del. C. § 3573(2).

#### **E. Income Tax Considerations.**

There are income tax issues to address when creating a Delaware asset protection trust under the Act. When creating the trust the grantor has two income tax options. The trust may be drafted as a grantor trust for income tax purposes or may be drafted as a non-grantor trust.

- (1) Grantor Trust. Under a typical Delaware asset protection trust, grantor trust status will generally occur. Normally the grantor retains a beneficial interest in the trust as well as a limited power of appointment to direct the disposition of the trust

assets upon the grantor's death. The assets of the trust will be fully includable in the grantor's estate for federal estate tax purposes and typically the trust will be taxed as a grantor trust for income tax purposes. Even if the trust has been drafted as a completed gift for federal gift tax purposes, it may make sense for the trust to be a grantor trust because the trust is permitted to grow income tax free (the payment of income tax by the grantor is not considered to be an additional gift to the trust). The following specific powers retained by the grantor will result in grantor trust status:

- (a) The grantor's retained right to discretionary distributions of income and principal should be sufficient to obtain grantor trust status under Section 677(a) of the Internal Revenue Code.
  - (b) The grantor's retained power to veto distributions from the trust should also result in grantor trust status because under Section 674(a) of the Internal Revenue Code, the grantor is treated as the owner of any portion of the trust in respect to which the beneficial enjoyment of principal or income is subject to a power of disposition exercisable by the grantor without the approval or consent of an adverse party. If the grantor is able to veto distributions from a trust, then a grantor is in a position to control the beneficial enjoyment of principal or income from the trust without the approval or consent of an adverse party.
  - (c) The grantor's retention of a limited power of appointment over the trust assets should also cause grantor trust status (provided the income of the trust may be accumulated during the grantor's lifetime at the discretion of the grantor or a nonadverse party) because the grantor is retaining the ability to effect beneficial enjoyment of the property under Section 674(a) of the Internal Revenue Code.
- (2) Non-Grantor Trust. In certain situations it may be advantageous to draft the trust as a non-grantor trust. If the trust is a non-grantor trust, Delaware law provides that state income tax is not imposed on trust income (including capital gains) accumulated for eventual distribution to non-resident beneficiaries. 30 Del. C. § 1636. This could result in significant tax savings in states with high income tax rates. A client who is contemplating the sale of a low basis asset (such as a closely-held business interest) could transfer the assets to a Delaware asset protection trust structured as a non-grantor trust and potentially avoid the imposition of state income tax. It may prove to be somewhat difficult to draft a Delaware asset protection trust as a non-grantor trust. However, the following mechanisms may be used to create a non-grantor Delaware asset protection trust:
- (a) The trust agreement may appoint an adverse party to consent to distributions to the grantor. The consent of an adverse party is a general exception to Sections 674 and 677 of the Internal Revenue Code. The trust agreement would provide that any distributions to the grantor would

be subject to the consent of one or more of the beneficiaries.

- (b) A testamentary limited power of appointment constitutes an ability to effect beneficial enjoyment of the property under Section 674(a) of the Internal Revenue Code, and as such results in grantor trust status. However, pursuant to Section 674(b)(3) of the Internal Revenue Code, an exception exists if this power is exercisable only by the grantor's last will and testament. The exception does not apply if income is accumulated during the grantor's lifetime if the power is exercisable without the consent of an adverse party. As such, the trust agreement should be drafted to provide that income may only be accumulated during the grantor's lifetime with the consent of an adverse party.

# EXHIBIT C

COURT OF CHANCERY OF THE STATE OF DELAWARE

## STANDING ORDER

IN RE: PROCEDURE FOR FILING CONSENT PETITIONS FOR  
TRUST MATTERS WITH THE REGISTER IN CHANCERY

WHEREAS, the following is a checklist of the requirements for filing consent petitions with the Register in Chancery relating to trust matters,

NOW, THEREFORE, it is ORDERED this 2nd day of June, 2010, the following requirements shall become effective immediately:

1. A letter from the filing attorney stating the material purpose of the petition shall accompany the petition.
2. A copy of the trust instrument, amendments thereto and any orders relating to the trust instrument shall be attached as exhibits to the petition.
3. Unless the relationship of those with a beneficial interest in the trust to the trustor is self evident, the filing attorney shall enclose with the cover letter accompanying the petition a family tree or other document showing the relationship of those having a beneficial interest in the trust to the trustor.
4. The petition shall include, as exhibits, consents or notices of non-objection ("Consents") to the relief sought in the petition from all whose interest in the trust is affected by the petition. This may include, but shall not be limited to, (i) trustees and other fiduciaries unless they have otherwise signified their consent to the petition by acting as a petitioner or accepting a fiduciary position; (ii) trust beneficiaries, who will generally be those with a present interest in the trust and those whose interest in the trust would vest, without regard to the exercise or non-exercise of a power of appointment, if the present interest in the trust terminated on the date the petition is filed; and (iii) all other persons having an interest in the trust pursuant to the express terms of the trust instrument (such as, but not limited to, powerholders and persons having other rights and powers, held in a non-fiduciary capacity, with respect to trust property). A trust beneficiary's Consent must be executed by (i) the

beneficiary personally; (ii) the beneficiary's attorney ad litem; (iii) a person authorized to virtually represent the beneficiary pursuant to 12 *Del. C.* § 3547 or any successor statute; or (iv) a person authorized by applicable law to represent the beneficiary with respect to the petition (such as, but not limited to, the beneficiary's attorney-in-fact or the Attorney General in the case of certain charitable beneficiaries). A Consent may, but need not, waive notice of draft reports, reports, hearings or other matters relating to the petition.

5. Consents executed pursuant to 12 *Del. C.* § 3547 (Delaware's virtual representation statute) shall include a reference to the statute, state the relationship of the person signing the consent to those virtually represented and include in the signature block the name of the person signing the Consent and the class of those virtually represented.

6. All Consents must be acknowledged by a person authorized to notarize documents (or a similar official if a document is signed in a foreign jurisdiction) unless there is justifiable cause why the Consents cannot be acknowledged and the court waives the requirement of an acknowledgment.

7. All Consents must have a signature line beneath with the name of the individual signing the Consent typed or printed.

The foregoing requirements are essential to the efficient processing of consent petitions. They are effective for all petitions filed with the Register in Chancery on or after the date set forth below.

  
Chancellor